EAST Search History

Ref #	Hits	Search Query	DBs	Default Operator	Plurals	Time Stamp
L1	97	(employee adj1 stock adj2 plan) or (employee adj1 stock adj1 option)	US-PGPUB; USPAT; EPO; JPO; DERWENT	OR	OFF	2007/12/17 18:16
L2	78	(vest$ adj2 option)	US-PGPUB; USPAT; EPO; JPO; DERWENT	OR	ON	2007/12/17 18:17
L3	3	1 same 2	US-PGPUB; USPAT; EPO; JPO; DERWENT	OR	ON	2007/12/17 18:25
L4	2	"6269346".pn.	US-PGPUB; USPAT; EPO; JPO; DERWENT	OR	ON	2007/12/17 18:25

EAST Search History

L5	30	("4346442" | "4376978" | "4597046" | "4674044" | "4700297" | "4774663" | "4815741" | "4823265" | "4953085" | "5077665" | "5126936" | "5132899" | "5136501" | "5206803" | "5210687" | "5227967" | "5233514" | "5262942" | "5270922" | "5297032" | "5315634" | "5671363" | "5710889" | "5765144" | "5781654" | "5826243" | "5890141").PN. OR ("6269346").URPN.	US-PG PUB; USPAT; USOCR	OR	OFF	2007/12/17 18:26

09/669,057 Employee Stock Option Planner

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Set     Items   Description
S1      89524   (ESOP OR (EMPLOYEE (1W) STOCK (1W) PLAN))
S2          0   (VEST??? (2N) (SCHEME OR SCHEDULE)) (20N) (EXCERCISE (1W) -
              PRICE) (20N) (STOCK (1W) PRICE)
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09/669,057 Employee Stock Option Planner

S3	6927	(STOCK (1W) OPTION?) (10N) (MODEL OR TOOL OR SOFTWARE)
S4	3714	(PROJECT??? OR ESTIMAT??? OR TAGET???) (5W) (STOCK (1W) PR-ICE)
S5	49	S3 AND S4
S6	41	RD S5 (unique items)
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S8	3	S7 AND TAX
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Accounting for employee stock options as contingencies
Lew, Albert Y; Schirger, Joseph F
Journal of Applied Business Research v10n1 PP: 19-24 Winter 1994 ISSN: 0892-7626 JRNL CODE: JRH
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ABSTRACT: The accounting profession has long attempted to improve the disclosure of compensatory stock option information in financial reporting. Adherence to current generally accepted accounting principles applicable to stock options can lead to the understatement of compensation expense in financial statements. The Financial Accounting Standards Board (FASB) has tentatively concluded that these shortcomings can be overcome if compensation cost is measured on the basis of fair value. A possible solution to accounting for employee stock options is to treat all options as contingencies. Users of financial statements would benefit from this recommendation since it would result in uniform disclosure and recognition of options.

TEXT: INTRODUCTION
In March 1984, the Financial Accounting Standards Board (FASB) added to its agenda a project dealing with the accounting for employee stock options. However, the Board could not agree on an approach to the valuation of stock options and in 1988 it decided to address the issue in its broader project on distinguishing between debt and equity instruments. Even though the FASB did not resolve the measurement problem, it did conclude that (1) the granting of stock options does result in compensation expense and (2) the measurement of cost should be based on fair value. This article proposes that the framework developed in SFAS No. 5, "Accounting for Contingencies," be applied to employee stock options. This approach has the advantage of avoiding the need to identify a ***stock option*** pricing ***model*** that will measure fair value while reporting the contingent results of stock option plans.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Current GAAP requires that the option plan (1) be classified and (2) that different measurement techniques be applied to fixed and variable plans. Under ARB No. 43, the compensation expense for a fixed plan is measured only to the extent the market price of stock exceeds the exercise price of the option at the date of grant. This practice is based on the notion that price changes after the grant date represent speculative investment gains and not compensation expense for services rendered.

ARB No. 43's limited scope (fixed plans only) led to the issuance of APB Opinion No. 25, "Accounting for Stock Issued to Employees." Although APB Opinion No. 25 deals with issues raised by variable performance plans, it does not supersede provisions for fixed option plans set forth in ARB No. 43. Under APB Opinion No. 25, the exercise date is set as the measurement date for actual compensation; however, it does require that estimates of expense be made at the end of each period. Each end-of-the-period estimate is accompanied by an adjustment of prior estimates of expense. The adjustment is based on a prospective method whereas revised differences between the new estimate and previously recorded amounts are allocated to current and future periods.

The variable performance plans of APB Opinion No. 25, which tie employee compensation to market performance, are similar to the stock appreciation

right plans employed by many firms. Stock appreciation right plans differ from the earlier variable plans since they distribute share appreciation in the form of cash or stock without requiring the employee to make a cash payment to acquire the right. In accounting for stock appreciation rights, FASB Interpretation No. 28 modifies the method of accrual in APB Opinion No. 25 to measure compensation. It entails a catch-up cost be provided prior to the exercise of the right or its expiration. Under this rule, the adjusting entry at the end of any current year of a multi-year service period ensures that the cumulative percentage of the total current estimated compensation is recognized.

The disparity between the accounting for fixed and variable stock option plans exists because of the difference in the use of measurement dates. While it is true that each type of option has its unique features and, therefore, may be resolved on its own merit, the argument is unconvincing with respect to employee stock options. Stock options are, in substance, contingent claim arrangements. The fundamental symmetry between stock options and contingencies should be accompanied by similar accounting treatment.

INCONSISTENT PRACTICE

A viable accounting standard derives its authority from its (1) conceptual validity and (2) ability to portray the underlying business reality and economic facts. Failure to meet both tests has serious accounting implications. Unfortunately, accounting standards on employee stock options leave much room for disagreement as to how economic reality is to be reflected. Because the standards employ different measurement dates they report different compensation expense for the same set of economic facts. This can be illustrated by the following two scenarios.

SCENARIO 1

On January 1, 1987, the hypothetical Wright Industries, Inc. granted an employee the option to buy 1,000 shares of its common stock at $10 per share when the market price also was $10 per share. The option was in effect for two years. The market price of the stock was $11 on December 31, 1987 and $14 on December 31, 1988.

Since information on the number of shares and the exercise price was available on the date of grant, ARB No. 43 applies. Because there were no difference between the market price of the stock, and the exercise price of the option, it is not necessary for Wright recognize any compensation. Under ARB No. 43, Wright Industries, Inc. will not have to recognize any expense even if the employee exercised the option when the market price was $14 on December 31, 1988.

SCENARIO 2

On January 1, 1987, Wright Industries, Inc. also granted 1,000 stock appreciation rights, payable in cash, to another employee. The market conditions of Scenario I are applicable since the rights are attached to the single class of common stock, issued by Wright.

Under the conditions of this scenario, FASB Interpretation No. 28 is applicable and the company obligated to report $1,000 estimated compensation expense in its financial statements of December 31, 1987. If the employee received $4,000 in the form of either cash or stock on December 31, 1988, total actual compensation cost to the company would be

$4,000, with $3,000 reported in 1988.

These two scenariôs highlight a fundamental conceptual flaw in current generally accepted accounting principles. In each case, the employee received the same economic benefits and assumed identical levels of risk before December 31, 1988. Sound accounting principles should reflect this economic reality and report the same compensation expense for the plans of Scenario 1 and 2.

Nonrecognition of compensation expense is permissible under ARB No. 43, even though Wright Industries is likely to claim a ***tax*** deduction of $4,000 in 1988.(1) This deduction is allowed under he assumption that Wright gave the employee something worth $14,000 in exchange for $10,000 of cash. To contend that there is no cost to the shareholders who own the company in this case requires that the opportunity cost to the shareholders be ignored.

Some may argue that common stock, by definition, is not an asset of the issuing entity, and therefore using it in exchange for employee service does not result in a cost to the company. Separating the entity from the shareholders is not only a narrow vision of the firm, but a departure from economic reality.

THE MEASUREMENT DILEMMA

At least two reasons can be given to explain why the FASB has not issued an exposure draft or the needed standard on accounting for employee stock options: 1) industry resistance to a standard that would increase the recognition of compensation expense on the financial statements, and 2) the use of fair value as the measurement surrogate for options. The use of stock-based compensation by industry is innovative and complex. Industry has developed variations from the plans that existed at the time ARB No. 43 and APB Opinion No. 25 were issued. Under these pronouncements, the recognition of cost in financial statements for the contrived plans is not required. Thus, changes that mandate the increased reporting of compensation expense is bound to evoke dissent. The Board's constituents are determined to keep compensation expense "off the books." Hence, it is reasonable to expect that the deliberative process of the Board will be stalemated by proposals that increase the recognition of the expense associated with stock option plans.

The Board has pursued fair value as the measurement surrogate for options. The fair value of an option consists of two key elements: intrinsic value and time value. Intrinsic value represents the difference between the exercise price of the option and the market price of the stock on any given date. Its value can be positive or negative. But fair value can only be positive because it represents the ability of the employee to benefit from future stock price appreciation. Time value diminishes to zero on the exercise date since both fair value and intrinsic value are identical.

Currently, the FASB believes that the best good faith estimate of fair value is to be measured through available option pricing models. The Board originally supported the Minimum Value Method but switched to the Black-Scholes Option Pricing Model. According to the Minimum Value Method, compensation is measured as the market value of the stock on the measurement date less the present values of the exercise price and estimated future dividends during the option period. The Black-Scholes Model is more complex because it incorporates probability estimates relating to the future variations in the market price of the stock. With

the rejection of the Minimum Value Method, the making of estimates on the fair value of options is removed from traditional accounting measurement techniques. Stochastic estimates have to be made by investment bankers or other outside financial specialists. Thus, accounting for stock compensation becomes not only a presentation of management's expectations but also a 'what-if' scenario that management may not necessarily believe will happen. Overly optimistic or pessimistic ***estimates*** of ***stock*** ***price*** changes can result in material misstatements. Whether these misstatements result from honest, but incorrect estimates on the one hand, or deliberate misrepresentations on the other, the outcome is the same--misleading financial reporting and exposure of the reporting firm and the auditor to litigation.

Thus, the need for a realistic measure is clear. While it is easy to criticize the existing practice of defining compensation as intrinsic value, it is hard to accept that option pricing models are viable alternatives. The Minimum Value Method and the Black-Scholes Option Pricing Model do have certain conceptual merits and possess varying degrees of success outside the accounting function. When applied to employee stock options, these professed virtues rapidly disappear. Employee stock options are unlike regular options because they are not transferable. It is reasonable to assert that the value of employee and non-employee stock options should differ, but few accountants would know by exactly how much. For this reason, companies would incur substantial costs to engage outside specialists to perform the periodic valuations of options throughout the vesting period. This is especially troublesome for start-up companies. It is likely that the fair value of options for these companies is minimal. They would, however, be incurring costs just to prove that immaterial and questionable compensation indeed results from their plans.

THE CONTINGENCY FRAMEWORK

Some accounting problems in employee stock options are manageable. Other issues, particularly the measurement of the fair value of options, are difficult to resolve. An immediate task should be to follow the original intent of the Board and to correct the inconsistencies in Opinion No. 25 and related pronouncements. However, the Board's recently expressed preference to use grant date measurement for fixed option plans, and a different date for variable plans does not provide for a consistent measurement of the expense. Inconsistencies in accounting for stock options plagued the Accounting Principles Board and apparently they continue to plague the FASB.

Events must be measurable before they can be recognized. This statement captures, to a great extent, the essence of the difficulty in the measurement of compensation in stock options. It is wishful to think that the measurement of the cost of stock options can be an exact science; rather, the problem should be viewed as relative. In this context, the use of valuation option models is merely one of the alternatives available to measure cost. These models are invalid under conditions where their basic assumptions do not hold.

SFAS No. 5, "Accounting for Contingencies," establishes a series of probability tests that are applied to a certain set of events before identifying the accounting rule for their recognition. Under SFAS No. J, the probability of an event's occurrence takes the form of a continuum with the following range.

--Probable: The future event or events are likely to occur.

--Reasonably Possible: The chance of the future event or events occurring is more than remote but less than likely.

--Remote: The chance of the event or events occurring is slight.
If the chance of occurrence of a future event is "probable" and the amount of loss can reasonably be estimated, SFAS No. J specifies the loss be recognized. The loss is included in the determination of the period's income. In the absence of a precise estimate, but with a reasonably estimated range for the loss, FASB Interpretation No. 14 requires the minimum amount of the loss deemed probable be reported. Disclosure of the loss in note form is acceptable only if none of these conditions exists, but there is a "reasonable possibility" that a loss will be incurred.

The need to recognize and disclose compensation expense exists. The principles pertaining to the "contingencies problem" can be applied to measure the expense associated with stock options. Applying the contingency rules to stock options results in reporting criteria as presented in Table 1. (Table 1 omitted)

The estimate of the probability that market price will exceed the exercise price for each type of employee stock option being exercised in the future must be made. The estimate is a function of the difference between the exercise price of the options and the future market price of the stock. The process involves the same estimates that are required under APB Opinion No. 25. Hence, the fact that compensation hasn't been recognized in the current or previous periods does not preclude the accrual of expense in subsequent periods.

The use of contingencies as an analogy to find an alternative solution to the option pricing problem can be defended on grounds of technical feasibility and conceptual merits. By setting the exercise date as the measurement date, it departs from the current position which designates the date of grant and the date of entitlement as the measurement dates for fixed plans and junior stock arrangements, respectively.

Clearly, all stock options are deferred arrangements implemented to maximize employee commitments. These commitments are obtained, however, at a cost because an option that is exercisable in the future is likely to have value. If exercised in the future, the company is deprived of a determinable amount of cash for its alternative use. Should no option contract exist, the company can sell the designated shares on the exercise date for the going market price. Final settlement of the amount of compensation with an adjustment for all previous estimates captures the full extent of the opportunity cost to the company. Compensation thus measured is more consistent with the concept of comprehensive income and with the layman's understanding of reward and expense. And, above all, it stops evasion of expense through loopholes permitted under present general accepted accounting principles.
CONCLUSION

Adherence to current generally accepted accounting principles applicable to stock options can lead to the understatement of compensation expense in financial statements. In addition, current GAAP treats different types of options with the same economic substance in an inconsistent manner. The FASB has tentatively concluded that these shortcomings can be overcome if compensation cost is measured on the basis of fair value. The Board also believes that periodic compensation costs for options should be charged to expense between the date of grant and exercise, with final measurement to be settled on the date of exercise. However, the Board does not embrace the

date of exercise as the exclusive measurement date since the grant date is used for fixed option plans.

At the present time, the Securities Exchange Commission has proposed major reforms that would eventually mandate clearer explanations and disclosures of executive compensation in corporate proxy statements and other SEC filings. Given the SEC's proposed requirements, one would expect that the FASB would address the accounting problems of reporting stock options in corporate financial reports in a timely manner. However, the Board seems unable to extricate itself from the difficult, if not impossible task of measuring compensation through the use of available stock option pricing models. The FASB may be able to solve this technical problem, but it cannot be assumed that the solution will come quickly.

This paper suggests a solution to accounting for employee stock options by treating all option plans as contingencies. Users of financial statements would benefit from this recommendation since it would result in uniform disclosure and recognition of options. In cases involving highly complex and controversial issues, the realistic approach of solving a problem through its manageable parts is typically required. It is with this spirit that an analysis of the problem on employee stock options has been performed, and the suggestion that the contingency framework be applied to the stock option problem.

SUGGESTIONS FOR FUTURE RESEARCH

The proposed application of the contingency ***model*** in the measurement of employee ***stock options*** is necessarily pragmatic and provisional. With the advancement of stock option measurement techniques the proposal suggested in this paper may be revised or replaced. In particular, there is a need for a research effort that will lead to the development of measurement techniques applicable to non-transferable stock options.
Executive compensation in the form of stock options is now under close scrutiny from Congress, the Securities and Exchange Commission, and special interest groups associated with publicly traded corporations. The controversy on executive stock option compensation stems, to a great extent, from its seeming excesses and the lack of disclosure in corporate financial statements. Research studies linking executive performance to incentive programs and the cost of these (incentive) programs will provide valuable information for formulating improved corporate compensation and accounting policies.

ENDNOTES

1. The plan must qualify as an "ordinary or non-statutory" arrangement under IRC Section 83 for this to be true. It is most like that the firm will design the plan to qualify for the deduction.

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THIS IS THE FULL-TEXT.

...TEXT: employee stock options. This approach has the advantage of avoiding the need to identify a ***stock option*** pricing ***model*** that will measure fair value while reporting the contingent results of stock option plans.

GENERALLY...

...is permissible under ARB No. 43, even though Wright Industries is likely to claim a ***tax*** deduction of $4,000 in 1988.(1) This deduction is allowed ...what-if' scenario that management may not necessarily believe will happen. Overly optimistic or pessimistic ***estimates*** of ***stock*** ***price*** changes can result in material misstatements. Whether these misstatements result from honest, but incorrect estimates... to the stock option problem.

SUGGESTIONS FOR FUTURE RESEARCH

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Treatment of executive compensation
Balsam, Steven
Pennsylvania CPA Journal v63n3 PP: 8-11 Spring 1993 ISSN: 0746-1062
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DOC TYPE: Journal article LANGUAGE: English LENGTH: 4 Pages
WORD COUNT: 1861

ABSTRACT: Stock options for executives are less expensive for accounting purposes than cash or other forms of stock-based compensation. Nonetheless, they are valuable to employees and costly to shareholders. Few agree with the current method of accounting for employee stock options. Stock appreciation rights (SAR) are similar in substance to stock options. They allow an employee to benefit from the appreciation in stock price by receiving the difference between the stock price at exercise and the price of the stock at the date of the grant. The employer is required to recognize over the life of the SAR the amount of cash paid or stock given to the employee. This approach allocates the expense over the entire period from the date of the grant to the date of exercise, waiting until exercise to determine the ultimate expense. Employee stock options should be accounted for in the same way as SARs.
TEXT: In its May 25, 1992 compensation issue, Forbes reported that Anthony O'Reilly, Chief Executive Officer (CEO) of Heinz, received compensation of over $75 million for the fiscal year ending May 1, 1991. The components of his compensation package were as follows: (chart omitted)

For accounting purposes, the salary and other cash compensation, as well as the management incentive awards, were charged to expense in 1991, while the long-term incentive awards were charged to expense over the three year period ending with 1991. However, no expense was recognized for the almost $71.5 million in stock option gains that Dr. O'Reilly recognized.

Under Generally Accepted Accounting Principles (GAAP), there is no charge to earnings (neither at issuance, nor at any time during the options life) if the options are issued under a plan that is deemed to be non-compensatory,(2) or if the plan is compensatory, but the exercise price of the option is greater than or equal to the fair market value of the stock at the measurement date (the first date on which both the exercise price and the number of shares granted are both known).

If the exercise price is less than the fair market value, the difference, multiplied by the number of options granted, is recognized as expense over the periods benefitted.(3) However, the overwhelming majority of stock options are granted at prices greater than or equal to the current stock price.

In these cases, stock options are less expensive for accounting purposes than cash or other forms of stock-based compensation for which expense recognition is required.

Nonetheless, options are valuable to employees and costly to shareholders. Options offer the right to buy shares at a fixed price (usually the share price at the date of grant) over a period of time (usually 10 years). They become valuable if the stock price increases because the holder can then

buy the stock at a discount.

The options are costly to shareholders because exercise dilutes their percentage of ownership in the firm and their claims to future cashflows.(4) Since the grant of employee stock options imposes a cost on the shareholders, that cost should be recognized in the firm's financial statements. To ignore costs arising from the grant of stock options, when the grants are valuable and the amounts measurable, understates expenses and overstates income, thus violating the principles of matching and conservatism.

THE CURRENT DEBATE

Few agree with the current accounting for employee stock options. The magnitude of stock compensation, combined with its lack of disclosure and accounting recognition, have caused concern in both Washington and Stamford. Senator Carl Levin held hearings in January of 1992 on the "Stealth Compensation of Corporate Executives" and has introduced the "Corporate Pay Responsibility Act," which would require that an expense be recorded in the financial statements for the grant of stock options. In July 1992, the Securities and Exchange Commission released proposed rules (release nos. 33-6940 and 34-30851) that would increase disclosure of all executive compensation in the proxy statements issued to shareholders. It would require firms to present a table showing the value of the options granted to executives assuming the stock price were to increase 50% and 100%. The Financial Accounting Standards Board (FASB) has had accounting for stock options on its agenda since 1984. While board members unanimously agree that an expense should be recognized, the consensus breaks down in determining how and when.

In 1986, the FASB tentatively concluded that options should be valued at fair value, as long as fair value is not less than the so-called minimum value (see example a). A problem is that there is no such thing as fair value. Fair value in accounting is usually established by a trade between two unrelated parties, or by reference to some quoted market price.

Employee stock options are granted in exchange for services rendered. Unfortunately, neither the option nor the services have a well-established external value. Option pricing models (see example b) are inappropriate as many of their assumptions, such as tradability, do not hold.

PROPOSAL

Stock Appreciation Rights (SARs) are similar in substance to stock options. SARs allow an employee to benefit from the appreciation in stock price by receiving (in cash or stock) the difference between the stock price at exercise and the price of the stock at the date of grant.

The benefit to an employee from a SAR is virtually identical to that from a stock option. The cost to the corporation is equal to the opportunity cost of selling the stock to the employee at the exercise price of the option rather than selling the stock to outsiders at the market price. Yet the accounting treatment is different.

The employer is required to recognize over the life (the date of grant until the date of exercise or expiration) of the SAR the amount of cash paid or stock given to the employee. It makes sense that the same accounting be used for transactions which have the same economic substance. Therefore, I propose that employee stock options be accounted for as we currently account for SARs.

The SAR approach, rather than recognizing an expense at the time of grant (which some argue is the date of the exchange), or over the vesting period, allocates the expense over the entire period from the date of grant to the date of exercise, waiting until exercise to determine the ultimate expense.

Prior to vesting, the final expense is ***estimated*** using the end-of-period ***stock price*** and is pro rated over the vesting period subsequent to vesting. At the end of each period, the expense is marked-to-market, i.e., the expense is adjusted based on the expected payout on the end-of-period stock price.

Allocating the expense over the life of the option, rather than at the time of grant or over the vesting period, makes sense given that (with certain exceptions) the option may only be exercised while the employee is employed by the company.
Only by continuing to work for the company does the employee earn the right to share in the continued appreciation of the stock price. In that sense, the option is not compensation for past performance at the date of grant, but compensation for remaining with the company, even past the option's vesting date. Recognizing increases in the value of the option over its life is consistent with matching the expense to the benefits received by the employer (continued service by employee). While the interim estimates of expense might ultimately prove to be wrong, at exercise, the cumulative expense recognized would equal the opportunity cost to the firm. Of the alternative methods, this is the only one in which the cumulative expense recognized actually equals the opportunity cost to the firm and, in most cases, the deduction allowed by the Internal Revenue Code.(5)

The following example illustrates expense recognition for a single option grant under current GAAP, the Minimum Value Method put forth by the FASB, the Black-Scholes Option Pricing model, the SAR approach proposed in this paper and the Internal Revenue Code. See Example c. (Example c omitted)

The following can be seen from the example shown. Under current GAAP, no expense is recognized because the exercise price is equal to the stock price at the date of grant. Second, under the Minimum Value and Black-Scholes models, the amount recognized as expensed is fixed at the date of grant and amortized over the vesting period.

This expense is indifferent as to whether or not the option is ever exercised, and can be greater or less than the actual profit to the employee and ***tax*** deduction to company. Both models ignore the benefits earned by the employee by continuing to work after the options vest. Third, only the SAR approach recognizes the continuing benefits earned by employees after the options vest.

In addition, regardless of when, or if, the option is exercised the cumulative accounting expense recognized is equal to the ***tax*** deduction taken by the company. The SAR approach is the easiest to understand and implement.

The above methods can also be illustrated using public companies, for example Heinz (options vest over one to five years, so a three-year period is used in calculation of expense). See Example D. (Example D omitted)

For Heinz, the Minimum Value is greater than that from the Option Pricing model and thus would be used under the FASB proposal. In all three years, the SAR approach s yields a significantly greater expense than either model

or the actual deduction allowed under the Internal Revenue Code. Note that under each of the approaches the expense is material relative to pretax income.

ADVANTAGES OF THIS APPROACH

Accounting for stock options as we currently account for SARs has several advantages. First, it reconciles accounting for transactions with similar economic consequences, stock options and stock appreciation rights. Second, the expense recognized is equal to the opportunity cost to the firm. Third, in most cases it reconciles financial accounting for stock options with ***tax*** accounting, as the cumulative expense recognized at date of exercise is equal to ***tax*** deduction taken in year of exercise. The approach is both informative and relatively easy to understand. The FASB's recent pronouncements have resulted in disclosures that have been anything but easy to understand.

FOOTNOTES

1. The gain upon exercise, $71,458.924, was calculated as follows: 3,172,320 options exercised x ($32.50 market price--$9.9742 exercise price)

2. For a plan to be noncompensatory the following four conditions must be met:

* Participation by all employees, some exceptions allowed.

* Equal offers of stock to all eligible employees.

* Limitation on time allowed to exercise option or purchase stock.

* Discount from market price not too large (10-15%)

3. In either case current GAAP ignores appreciation in the stock's price between the date of grant and the date of exercise.

4. Alternatively, the company could have sold the shares. The (opportunity) cost can then be measured as the difference between the cash received upon exercise of the option, and the amount that could have been received by selling the stock to outsiders.

5. No ***tax*** deduction is allowed for Incentive Stock Options.

Steven Balsam, CPA, Ph.D., is an accounting professor at Temple University. He previously thought accounting at Baruch College and the University of Rochester. He received his doctorate in Accounting from Baruch College, City University of New York in 1991.

EXAMPLE

A MINIMUM VALUE

The minimum value method was developed by the FASB to estimate the value of the option. It does so by subtracting from the current stock price the present value (nominal amount adjusted for the time value of money) of the exercise price and present value of dividends from date of grant to date of exercise.

B BLACK-SCHOLES OPTION PRICING MODEL

A well-known option pricing model was developed by Fisher Black and Myron Scholes. Their original model factors in the current stock price, the exercise price, the risk-free rate and volatility of the stock's price, but does not allow for dividends (Merton modified their ***model*** to allow for dividends). Some believe it overvalues employee ***stock*** ***options*** because it assumes tradeability and the ability to short-sell, but does not consider the effect of the continued employment requirement.

THIS IS THE FULL-TEXT.

...TEXT: waiting until exercise to determine the ultimate expense.

Prior to vesting, the final expense is ***estimated*** using the end-of-period ***stock price*** and is pro rated over the vesting period subsequent to vesting. At the end of...exercised, and can be greater or less than the actual profit to the employee and ***tax*** deduction to company. Both models ignore the benefits earned by the employee by continuing to...

...or if, the option is exercised the cumulative accounting expense recognized is equal to the ***tax*** deduction taken by the company. The SAR approach is the easiest to understand and implement...

...to the firm. Third, in most cases it reconciles financial accounting for stock options with ***tax*** accounting, as the cumulative expense recognized at date of exercise is equal to ***tax*** deduction taken in year of exercise. The approach is both informative and relatively easy to ...

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8/7,K/3 (Item 1 from file: 16)
DIALOG(R)File 16:Gale Group PROMT(R)

02815210 Supplier Number: 43782564 (THIS IS THE FULLTEXT)
Stock option rule proposed
Pensions & Investments, p33
April 19, 1993
TEXT:
By Vineeta Anand

NORWALK, Conn. - A proposed new accounting rule on stock options could encourage companies to adopt variable stock options and move away from plain vanilla options that are not tied to performance.

That shift should please shareholders, who have been clamoring for

increased pay-for-performance by corporate America, experts said. Yet, ironically, shareholders have been rallying against this proposal.

The Financial Accounting Standards Board has proposed the new rule, requiring the value of options granted to executives be recognized as an expense on corporate income statements.

Jude Rich, chairman of Sibson & Co. Inc., an executive pay consulting firm in Princeton, N.J., estimates the rule could lower pre- ***tax*** corporate profits by as much as 4% to 5%. Not surprisingly, the rule has drawn considerable flack from corporate bigwigs because companies do not have to deduct the cost of stock options from profits under current accounting rules.

Small and emerging companies with rapidly rising stock prices that give their executives hefty stock options instead of big salaries also have bitterly complained the proposal would hurt their ability to attract new talent.

Many pension funds worry the new accounting rule would reduce the value of equities in their portfolios, even though it would cause corporate profits to drop only on paper and would not affect actual cash flow.

In addition, the rule is likely to hurt junior executives and the rank and file who receive stock options at some companies, pay consultants say. One such company, PepsiCo Inc., Purchase, N.Y., however, says it has no plans of discontinuing its 'Share Power' program, under which all full-time employees receive options to buy company shares.

The accounting rule might encourage companies to adopt variable stock options, linked to defined performance goals, rather than the traditional stock options long preferred by firms, because the variable options might actually result in lower charges to their earnings.

ITT Corp., under pressure from shareholders to link executive pay to performance, adopted a variable stock option plan in 1991. Under that plan, executives may earn options to buy company shares only if the stock price rises 40% from stated levels, and stays at the higher levels for 10 consecutive trading days.

Current accounting rules discourage companies from using performance-based stock options because companies must mark to market the values of stock options each year to reflect subsequent increases or decreases in stock prices. These fluctuations make it hard for companies to estimate their charge to earnings each year. The new rule would eliminate this onerous provision.

The proposed standard also could result in a lower charge to earnings for companies using performance-based stock options because it would let them figure out the chances of reaching their performance goals and take those into account when estimating their charges. Then at the end of the period by which the performance goals must be met - or the options expire useless - companies must adjust charges to reflect if those goals had been met. Charges taken in earlier years, however, cannot be reversed if the performance goals aren't met.

'Institutional shareholders should look positively at that piece of the rules that will encourage companies to use more performance-based stock options, which they should want,' said Susan Eichen, principal in the New York office of William M. Mercer Inc., the compensation consulting firm.

But some institutional shareholders oppose adoption of the new standard. The proposal has drawn fire from the Council of Institutional Investors, the California Public Employees' Retirement System, General Motors Investment Management Corp. and various other public and corporate pension funds.

'We think it is unnecessary,' said Ralph Whitworth, president of the Washington-based United Shareholders Association.

Now, the only time institutional shareholders feel the pinch of stock options is when the options show up as an increase in the number of

outstanding shares. Companies must inflate the number of outstanding shares as soon as the stock options become exerciseable, even though executives may not actually have converted them into shares.

Nell Minow, a principal in LENS Inc., Washington, a shareholder activist fund, admitted 'It's a very tough issue.'

At the same time, many companies still adjusting to complying with new Securities and Exchange Commission rules have used traditional mathematical formulas such as the Black-Scholes ***model*** to disclose the value of ***stock options*** in their corporate proxies but failed to realize they can make adjustments that would lower those values.

The facts they typically overlook: many executives exercise their options early, while others leave the company before getting to exercise their options. The new accounting rule explicitly asks companies to make those adjustments in valuing stock options.

'An option that is exercised early is worth less than an option that is not exercised early, assuming the company does not pay dividends,' said Patrick Finegan, an independent New York-based financial consultant.

The FASB's new proposal on executive pay will cause employers to charge the value of stock options handed out to all employees as an expense against their income when issued. The charge would be evenly spread out over the years it takes for executives to become eligible to receive all of them, usually four years.

Companies may use any method to calculate the fair market value of options when they issue them, so long as the method includes standard criteria used in valuing stock options. Pay consultants expect most companies likely will use the Black-Scholes mathematical ***model***, widely used in pricing ***stock*** ***options*** , or a variation.

The rule would apply to all stock-based compensation, the most popular of which are stock options, as well as company shares sold to employees at a discount from the prevailing market price.

The accounting board is expected to publish this draft rule in June, and issue the final rule sometime next year after a six-month comment period.

Companies would not have to adopt the new accounting rule until 1997. In the meantime, they would merely have to disclose the value of stock options granted to employees as a footnote in their annual financial statements.

Because of the adjustments allowed by the FASB, the hit for corporations will be smaller than the value some companies have placed on stock option grants in their recent statements, under rules adopted last year by the SEC. The SEC lets companies value their ***stock*** ***option*** grants either by using a mathematical ***model*** such as the Black-Scholes formula, or by ***projecting*** values based on annual compound ***stock*** ***price*** increasing of 5% and 10%.

... an executive pay consulting firm in Princeton, N.J., estimates the rule could lower pre- ***tax*** corporate profits by as much as 4% to 5%. Not surprisingly, the rule has drawn...

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09/669,057 Employee Stock Option Planner

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